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SUBJECT: COMPARATIVE ANALYSIS OF LATVIA'S 2010 BUDGET

REF: A. RIGA 573 B. RIGA 611 C. RIGA 545

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¶1. Summary: Latvia's 2010 budget contains large across-the-board spending cuts and tax increases. Since 2008, a massive economic slowdown has caused central government revenues to contract 26.6% -- government spending has fallen 17%. As in 2009, payroll reduction rather than significant structural reform was again the most common cost cutting measure. The scale of expenditure cuts varied widely across ministries, with especially large reductions in the Ministries of Defense and Foreign Affairs, as well as a massive funding reduction on the energy department within the Ministry of Economy. The budget meets the conditions of the country's international assistance package, but amendments will be necessary to deal with the consequences of a Constitutional Court decision reversing pension reductions enacted in 2009 (ref B). End Summary.

#### Running the Numbers

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¶2. Parliament (Saeima) passed the government's 2010 budget on December 1 (ref A). Latvia's consolidated general government budget revenue is projected at USD 9.867 billion and expenditure is programmed at USD 11.075 billion. The 2010 budget deficit is estimated at 7.5% of GDP. Compared to the 2009 budget, this represents a 2.1% drop in total revenue, including an 8% reduction in tax revenue, and a 6.6% reduction in total spending. The budget assumes a 4.0% contraction of real GDP in 2010 and a 3.7% fall in consumer prices. These figures are consistent with Latvia's international financial assistance obligations.

¶3. To close the anticipated budget gap for 2010 this budget includes roughly USD 545 million in projected tax and non-tax revenue increases. These measures include the introduction of a small progressive real estate tax, an increase in the personal income tax rate to 26% from 23%, and higher excise taxes on natural gas, cigarettes and alcohol.

#### Deep Defense Cuts

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¶4. The magnitude of expenditure reductions across ministries varied widely. Social safety net spending (disability, retirement pensions, unemployment benefits) was largely protected from deep cuts. The Ministry of Defense faces one of the largest cuts. Defense spending in 2010 will be 1.13% of GDP or USD 279.704 million, which is 22.3% less than in 2009 and constitutes a massive 49.8% reduction compared to 2008. Payrolls costs have been trimmed by 43% from the 2008 level to USD 130.122 million, while expenditures for goods and services were reduced to USD 90.440 million which is by 25% less against the 2009 level and by 56.6% against 2008. The State Security Protection program, which includes the military intelligence services, faces an 11.1% cut compared to 2009 and a 16.2% cut compared to 2008 bringing its total budget down to USD 9.752 million.

¶5. The Latvian National Armed Forces (NAF) faces a 26.1% reduction in their budget compared to 2009 and a 52.4% cut compared to 2008,

reducing its funding to USD 178.992 million. The largest cuts are related to equipment, uniform and inventory procurement, maintenance, long term development projects, air search and rescue efforts, the Coast Guard, and the Security Police, as well as health care costs. Most of the savings will come from a general 20% pay cut, eliminating over 160 positions and reductions in living expenses compensation.

¶6. Budget reductions have forced the Latvian military to reduce its commitment in NATO Response Force-14 from an infantry company to a few staff officers. But despite these cuts, Latvia has remained fully committed to continuation of its deployment of 170 troops in Afghanistan, and to a full program of joint exercises and training with the United States and its Baltic neighbors, Estonia and Lithuania.

#### Foreign Affairs Cuts

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¶7. The Ministry of Foreign Affairs budget next year will be USD 52.042 million which is 12.8% lower than last year and 39% leaner than in 2008. Payroll will be reduced by an additional 22.5% in 2010 and will have fallen 45.8% since 2008. The budget for diplomatic missions abroad has been trimmed by 14.9% and by a staggering 40.4% from the 2008 level. Funding for assistance to Moldova, Georgia, Ukraine and Belarus has been practically eliminated, with only USD 1681.25 budgeted for 2010. This constitutes a 99.9% reduction compared to 2008 when the budget was over one million dollars. Despite these cuts the MFA does not plan on closing any diplomatic missions abroad.

#### Energy Department Cut

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¶8. The Ministry of Economy's budget will be slashed by a massive 74.4% in 2010 reducing it to USD 94.905 million; this constitutes

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the largest ministerial reduction. The Ministry has undergone a significant restructuring. The budget of the Ministry's Energy Department, the principal energy policy body in Latvia, will be slashed 57.9% compared to 2009, and will be 82.2% lower than its 2008 level, bringing its funding down to USD 1.154 million. However, the majority of the funding decrease for 2010 is explained by the completion a large scale EU co-financed geological exploration project for assessing additional underground natural gas storage potential.

#### Cuts Here, There and Everywhere

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¶9. The Corruption Combating and Prevention Office's budget will be a modest 5% less than in 2009 and 33.1% smaller than in 2008. Roughly half of the cuts will be come from restructuring the office, reducing pay and eliminating positions. The Ombudsman's Office (which receives and resolves human rights and other public complaints) will face considerable cuts. Its 2010 budget has been trimmed by 38.2% relative to 2009 (-57.1% relative to 2008) (ref C).

¶10. The Prosecutor General's budget will be 15.9% lower than in 2009 (-34.8 against 2008). Funds will be cut at the expense of staff compensation, including the Prosecutor General. Funding for the Money Laundering Unit will contract by 5.8% (-25% relative to 2008).

¶11. The President's Chancery next year will be operating with a 7.2% lower budget than last year. However, the Parliament's budget will actually increase by 1% versus 2009. The small increase will finance the NATO Parliamentary Assembly.

¶12. The budget for the Ministry of Health in 2010 will be USD 904.260 million, which constitutes a 4.6% decrease compared to 2009 (-24.8% against 2008). The Ministry's direct health care budget will be 11% less than in 2009 and 32.2% lower than in 2008.

¶13. The Ministry of Education's funding in 2010 will be USD 404.589 million, which is 7.5% reduction compared to 2009, and is 44.9% lower than the 2008 level. As a result of ongoing reforms in education, the total wage bill will shrink by 26.1% compared to 2009 and by a massive 74.4% compared to 2008 as teachers have faced severe wage contraction.

¶14. The Justice Ministry's budget will decrease by 6.8% compared to 2009 and by 19% compared to 2008 shrinking the total down to USD 195.691 million. The Court system will receive 9.4% less funding than last year (21% less than in 2008). Pay reductions to judges, staff and position eliminations will trim the wage bill 15.5% against 2009 (-26% against 2008).

¶15. The Ministry of the Interior faces an 11.6% cut compared to 2009 (-33.8% compared to 2008). The total allocation will be USD 330.004 million. The budget for the State Police will be 18.7% less than in 2009 and 40.1% smaller than in 2008. The budget of the Security Police will shrink by 10.7% compared to 2009 (-36.8% relative to 2008). The largest part of the cuts will affect pay. The State Border Guard will operate with 11.5% less funding next year (41.1% less than 2008).

¶16. Revenues in the Special Social Security budget next year, which includes retirement, disability and unemployment benefits, amongst others, are projected at USD 2.477 billion which is 5.9% less than in 2009 (19% less than 2008). Expenditure (USD 2.831 billion) will be 7.5% lower than in 2009, but 11.3% higher than in 2008. The higher level of expenditure compared to 2008 is the result of additional spending due to the high level of unemployment. In total, the social security budget will be 11.4% of GDP.

¶17. As passed by Parliament, USD 1.970 billion is to be allocated to financing retirement pensions. However, the Latvian Constitutional Court's decision on December 21st that pension cuts implemented in July 2009 were unconstitutional (see reftel B) will necessitate amending the budget and, without significant action, will impact the government's budget deficit projection.

¶18. COMMENT: Despite the massive expenditure reductions over the past two years, it is important to remember that the 2008 budget was bloated and unsustainable. Excessive government spending during the 2004-2008 boom period fueled a speculative overheating of the economy that led to a sharp 19% contraction of the economy in 2009. In order to restore the country's economic footing, the government needs meaningful structural reforms that improve efficiencies and smooth the delivery of services. The budget cuts are painful but necessary measures to comply with the country's international assistance package. Nonetheless, the ad hoc and rushed nature of the budget process thus far, primarily as a result of political squabbling, has led to an over-reliance on last minute, poorly planned and regressive expenditure cuts and tax increases, rather than serious reform. This has led to public rebukes from the

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Governor of the Bank of Latvia as well as the European Commission and, privately, by the IMF, which has stressed the need to ensure adequate progressive social protection given the severity of the economic decline. There is still time to enact structural reforms with the EC expected to outline recommended measures in its amended MOU. But with elections approaching in October and political squabbling intensifying there is little hope left for real reform. End Comment.